Chapter 5: Credit Issues

> *"The Secretary is authorized to enter into agreements with project sponsors containing terms and conditions designed to assist the projects in leveraging additional funds, while ensuring that the program operates in a fiscally-prudent manner."*
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> **TEA 21 Conference Report (105-550)**
> **May 22, 1998**

5.0 Introduction

The TIFIA statute provides a framework within which the DOT negotiates specific terms and conditions of the program's credit instruments. The statute authorizes the DOT to adopt the stance of the "patient lender" though such features as allowing the DOT to accept a subordinate lien on pledged revenues, back-loaded repayment schedules, repayment deferrals should revenues prove insufficient, and loan prepayments without penalty. Yet the statute also imposes financial standards to help the DOT manage risk, such as limiting TIFIA credit assistance to 33 percent of eligible project costs, requiring the project's senior debt to obtain an investment grade rating, and mandating non-subordination to the claims of other creditors in the event of a borrower's bankruptcy, insolvency or liquidation.

The TIFIA program's pragmatic challenge is to balance the objective of advancing transportation projects with the equally important need to lend prudently and protect the Federal interest. The DOT must apply rigorous credit standards as it fashions assistance to improve the financial prospects of participating projects. Establishing a satisfactory equilibrium between these objectives has formed the central challenge in implementing the statute.

This chapter describes policy issues that the DOT has encountered in the course of specific project negotiations. Because borrowers have sought assistance primarily in the form of direct loans, most issues have arisen in this area.

5.1 Intercreditor Issues

Intercreditor issues involve the relative rights and security of multiple creditors or investors in a project. They arise when TIFIA assistance is used in conjunction with capital markets or other debt as a funding source for the project. Generally, the project sponsor and other parties, such as underwriters and insurers acting on behalf of the senior bondholders, will seek to use TIFIA to maximize the creditworthiness of the senior debt obligations.

As noted above, TIFIA's pragmatic challenge is to enhance the financial viability of the overall project without exposing the DOT to excessive credit risk. When this requires a senior/subordinate debt structure, the DOT must assume a financing posture consistent with a minority-share, junior-lien investor. Stated succinctly, the Federal objective is not to minimize its exposure but to *optimize* its exposure—that is, to take prudent risks in order to leverage Federal resources through attracting private and other non-Federal capital to projects.

In addition, TIFIA differs from most other Federal credit programs. Federal loans and loan guarantees for agriculture, small business, maritime commerce and other activities typically comprise 80 to 90 percent of a project's funding sources. As the primary creditor, the Federal Government in those programs can dictate the borrowing terms and hold the senior lien position. In contrast, reflecting the objective of attracting private co-investment, TIFIA assistance is never greater than 33 percent of eligible project costs. As discussed above, in a situation with multiple creditors the DOT is willing to assume a subordinate lien on revenues pledged to repay project debt. For this approach to safeguard the DOT's financial position, however, the risks borne by both senior investors and TIFIA must be aligned. To date, five TIFIA projects have involved significant negotiations over the terms of a junior-lien TIFIA structure.

5.1.1 Non-Subordination

The TIFIA program's most notable departure from typical senior/subordinate debt structures stems from the statute's provision that, although the DOT can accept a junior lien on revenues, its claim must be on parity with senior bondholders "in the event of bankruptcy, insolvency or liquidation of the project obligor."[33] This non-subordination feature, giving the DOT the status of a senior creditor upon occurrence of unlikely circumstances, is often termed in the financial community as the "springing lien."

The non-subordination requirement has generated much discussion regarding TIFIA's ultimate benefit to a project's senior debt rating. Generally, investors focus on a project's future cash flows rather than its liquidation value. On this basis, the credit analysis will acknowledge that DOT's secondary claim on ongoing project revenues affords senior bondholders additional debt service coverage and diminished probability of payment default. By and large, projects with investment grade ratings reflect the likelihood that the borrower can meet scheduled debt service payments from pledged revenues, without regard to the collateral or liquidation value of the project. However, for weaker projects where the credit analysis must take into account the break-up or liquidation value of a failed enterprise, there would be a co-equal sharing of claims against the pledged security between the senior bondholders and the DOT.

Reports from the credit rating agencies reflect this tension in the TIFIA program design. A recent report[34] from Moody's Investor Services indicates that the non-subordination feature can be accommodated within project financings:

> "Although limited to a default scenario leading to issuer bankruptcy, insolvency and liquidation, the 'springing lien' feature poses some potential risks for issuers/project sponsors and investors – particularly for stand-alone or 'non-recourse' projects. Nevertheless, Moody's believes that project fundamentals and structural and procedural safeguards could moderate this risk substantially."

[33] The two provisions are that the DOT: "may have a lien on revenues…subject to any lien securing project obligations" (23 U.S.C. 183(b)(3)(B)), and that the DOT "shall not be subordinated to the claims of any holder of project obligations in the event of bankruptcy, insolvency, or liquidation of the obligor" (23 U.S.C. 183(b)(6)).

[34] "Moody's Analytic Approach To TIFIA: The Credit Impact Of The Springing Lien," Municipal Credit Research, Moody's Investors Service, January 2002.

Fitch Ratings takes a similar stance[35], noting that the non-subordination feature may mean that certain project financings may be too speculative for TIFIA assistance to reach:

> "The current statutory construct of the program, with its springing lien provision, is likely to prevent some borderline projects from reaping enhancement from the program, especially where their unenhanced credit position suggests a reasonable probability of default. For projects with speculative economic credentials, nothing continues to beat good old fashion equity, although this program probably reduces the equity requirements needed for an investment-grade rating….Legal flexibility exists within the loan agreements to mitigate (but not eliminate) most senior project debt concerns about the TIFIA springing lien."

5.1.2 Structuring TIFIA Repayments

As noted above, TIFIA enables the DOT to become the "patient investor" by aligning a repayment schedule more closely to a project's economics than may be typical in the capital markets. By "back loading" its repayment demands (instead of, for example, requiring level debt service or payment of all current interest due), the TIFIA program can facilitate the leveraging of a new or uncertain revenue stream that, while expected to perform well in the long run, may exhibit significant "ramp-up" risk during the early years of project operation. The challenge for the TIFIA program is in determining the appropriate degree of back loading, if any, on direct loans.

The clearest instance to consider back loading is for a project supported by user fees that will generate revenues only upon completion of construction. Given the typical need for such a project to build its user levels during the initial years of operation, it is not uncommon for both senior and junior debt to back load repayments to accommodate growing revenue. Consistent with bond financing convention, where the borrowed amount includes funds with which to repay interest during construction ("capitalized interest"), TIFIA also could agree to defer construction period interest payments, adding these accruals to the principal amount of the loan via a process known as "negative amortization."

On the other hand, in cases where project financings are supported by revenues that do not have a substantial ramp-up period and/or are not linked to project operations (e.g., taxes or other stable revenue sources), TIFIA back loading may not be needed to attract senior co-investment.

Each financing requires an examination of the proposed structure of the senior debt and any potential returns to project sponsors. The priority position in the project's flow of funds from senior debt investor to junior debt investor to project sponsor, based on increasing risk and expected rates of return, is an important credit structuring principle. Exhibit 5-A shows a typical flow of funds for a TIFIA project, and demonstrates how senior debt service as well as reserve accounts for the benefit of senior bondholders generally accumulate revenues ahead of TIFIA debt service.

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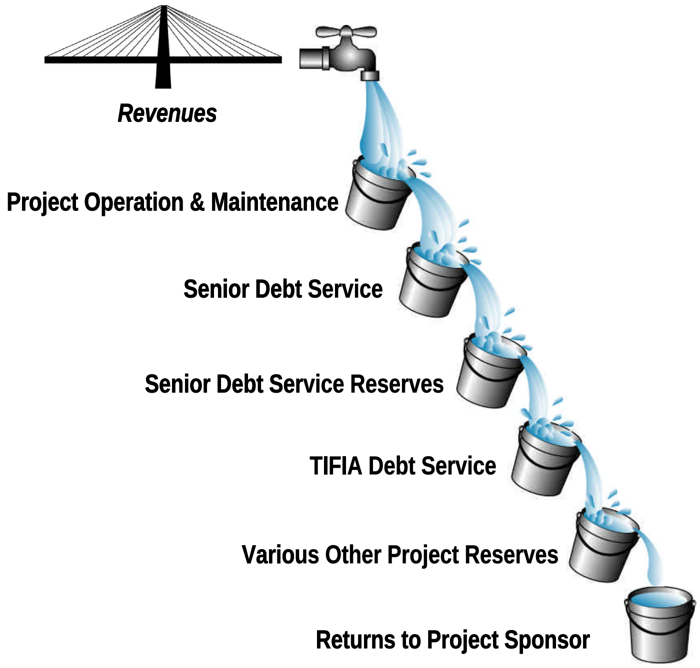
35 "TIFIA Springs Into Action: Credit Implications of This Surface Transportation Program," Project Finance Special Report, Fitch/IBCA, January 16, 2001.

Exhibit 5-A: Example of Project Flow of Funds



With the exception of the returns to project sponsors, the revenue applications either pay current project expenses or provide reserves against future or potential needs. Once revenues are remitted to the project sponsors, however, they are no longer available for the project.

5.1.3 Ensuring the Significance of the Investment Grade Rating

One of TIFIA's key financial disciplines is the requirement that a project's senior debt be rated in the investment grade category. This provision reflects practical financial considerations. Bonds rated lower than investment grade are considered speculative in nature, indicating riskier credits. Further, many institutional investors are prohibited from purchasing sub-investment grade bonds, indicating that a low-rated borrower likely would find bond financing either scarce or prohibitively expensive.

The rating requirement offers security to the DOT only if the same repayment source is being pledged to both the senior debt obligations and the subordinate TIFIA credit instrument. In such a structure, the investment grade rating for senior debt helps the DOT evaluate its credit risk as a subordinate lender; although the TIFIA instrument itself may be sub-investment grade, the higher rating on the senior debt indicates that the project's overall risk profile is manageable.

In addition, issuers often find that segmenting their bond offerings into two or more tiers can result in lower overall borrowing costs than issuing all of their debt in a uniform class. Typically, project sponsors seek to issue the maximum amount of senior-lien bonds without diluting their bond rating, and minimize the volume of junior-lien bonds, since senior debt represents a lower-cost source of capital. The challenge for the TIFIA program is to enable such a financing approach while protecting the Federal investment.

For example, the value implied by the senior debt rating can be eroded if the pledged revenue securing the project's senior debt differs from that securing the TIFIA instrument. In such an instance, a project may have a dependable repayment source for half its pledged revenues and a more speculative source for the balance. If the senior debt service matched only the dependable revenue source, the investment grade rating would not reflect project economics for the junior loan. The senior bonds would absorb the superior revenues entirely, effectively leaving the TIFIA loan with the more uncertain secondary source. In order to manage the risk of such a situation, the DOT has sought, on a subordinate basis, a pro rata share of the higher-grade revenue stream based on the relative amounts of senior and TIFIA debt.

Likewise, the value implied by the senior debt rating would be negated if the par amount of senior debt were substantially smaller than the TIFIA loan.[36] In this instance, a nominal volume of bonds might obtain an investment grade rating from a speculative revenue source supporting senior debt service that amounts to a small percentage of projected revenues. Due to the imbalance in issue sizes, the senior rating would not reflect the relative creditworthiness of the TIFIA loan. In order to manage the risk of this situation, the DOT has required that TIFIA assistance not exceed the amount of senior debt.

5.2 Line of Credit Issues

The line of credit is a standby instrument providing a supplemental source of capital during a project's ramp-up phase to mitigate the risk of uncertain revenues. Unlike a direct or guaranteed loan, it does not help fund construction costs as part of the project's initial capitalization. Rather, it represents a contingent commitment by the DOT to make one or more future direct loans to help fund a project's operating, capital renewal, or debt service costs in the event of revenue shortfalls. The line of credit is intended to facilitate a project's access to private capital by providing a cash flow cushion and enhancing debt service coverage, thereby helping the senior debt obligations receive an investment grade rating.

Three TIFIA project sponsors have requested lines of credit in conjunction with much larger direct loans to support their project financing. In each case, the borrower determined that being able to draw upon a TIFIA line of credit during the project's early operating phase, when the new, user-backed revenue stream is ramping up, would be an important component of an investment grade financing structure for its senior debt. To date, none of these financings has closed, nor have their TIFIA line of credit agreements been executed. During the course of preliminary negotiations, however, the parties have identified certain line of credit features that may influence the effectiveness of this instrument.

5.2.1 Conditions for Drawing upon the Line

Perhaps the most significant issue dealing with a line of credit arises with regard to when a borrower may draw upon the line. The TIFIA statute specifies that a draw can be made only if net revenues from the project (including moneys in debt service reserve funds and any other available reserve accounts) are insufficient to pay debt service or other eligible costs.[37] The clear intent is that the Federal line of credit be the last resort in the event of a revenue shortfall.

[36] For example, the sponsor of a $100 million project could propose funding sources of $5 million in senior debt, $33 million in TIFIA financing and $62 million in Federal grants, thereby technically complying with the 33% cap on TIFIA financing.
[37] 23 U.S.C. 184(b)(3).

The presence of the line of credit is intended to benefit the rating on the senior debt by being considered an additional revenue source for the purpose of pro-forma calculations of senior debt service coverage. However, TIFIA's requirement that all other reserve funds first be depleted before accessing the line may dilute its effectiveness, since most bond indentures treat un-restored draws upon an issuer's reserve accounts as a "technical" default. At that point, the availability of the TIFIA standby line of credit is too late to reassure investors or confer the desired rating benefit.

To address this concern, some borrowers have explored the use of a "gross pledge" flow of funds in which revenues are first pledged to senior debt service before payment of operations and maintenance (O&M) expenses. In such a structure, revenues would almost always be sufficient to pay senior debt service without tapping the debt service reserve fund, and the revenue shortfall that the TIFIA line of credit would be called upon to fill would be payment of O&M expenses. A gross pledge is somewhat unconventional in project financings, however, as the markets generally prefer a "net pledge" in which O&M expenses are paid before debt service expenses. In light of these challenges, some borrowers have indicated that having more flexibility to draw upon the line earlier, to forestall a technical default, would improve its utility.

5.2.2 Coordinating Draws with Loan Repayments

Another credit issue arises for the DOT where a TIFIA borrower is utilizing both a direct loan and a line of credit, due to the overlap between the direct loan's repayment period and the line of credit's draw period. Under the TIFIA statute, there is a five-year overlap period (years six through 10 following project completion) during which a borrower having both a direct loan and a line of credit must begin scheduled loan repayments and can still draw upon the line of credit. It is possible that one credit instrument could be used to satisfy the payment obligation on the other (e.g., a draw on the line of credit to help meet a direct loan payment). Furthermore, if certain terms were different (e.g., the interest rates on the two instruments varied significantly), the borrower could be motivated to manipulate the use of the instruments in a revenue shortfall situation. Such actions appear to be inconsistent with the statutory purpose of TIFIA.